United Nations E/1999/84

Economic and Social Council

Distr.: General
17 June 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 13 (j) of the provisional agenda*
Economic and environmental questions: international cooperation in tax matters

Ninth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

Report of the Secretary-General

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* E/1999/100 and Add.1.

99-18036 (E) 080799

I. Introduction

1. It its decision 1998/218, the Economic and Social Council decided that the ninth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters would take place in the first half of 1999, as envisaged in the proposed programme budget for the biennium 1998–1999, so that the report of the meeting might be submitted to the Council at its substantive session of 1999. Pursuant to that decision, the ninth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters was held in New York from 3 to 7 May 1999.

2. The Group of Experts observed that in the context of the evolving international economic environment and globalization, it has become necessary to explore ways and means, particularly in the international taxation area, to provide an enabling environment for expansion of international trade and capital movements across national boundaries to promote financial resource mobilization for the achievement of sustainable economic growth.

3. During the past decade, the advent of globalization has given rise to several beneficial global trends, more particularly, the liberalization of international capital movement. However, it has also led many countries to take advantage of opportunities to attract taxable bases from other countries to themselves and indulge in unfair tax competition.

4. Globalization may also lead to significant changes in other areas of tax systems involving, *inter alia*, a greater degree of international cooperation accompanied by the sacrifice of some fiscal sovereignty, and the possibility of the introduction of a global tax. There is also a need for the establishment of an institutional framework at the international level focused on international tax policy and other tax administration issues, which would reduce the impact and efficacy of tax havens, increase the scope for exchange of tax information, develop multilateral conventions and reduce the market distortions caused by transfer pricing issues.

5. International tax developments have also necessitated a re-examination of the taxability of factors of production or income tax. International capital movements have become increasingly sensitive to tax structure changes and non-tax factors, such as speculative attacks on currencies with underlying weaknesses. Most countries have realized that international financial capital cannot be taxed at internationally non-comparable rates.

6. The work of the Group of Experts provides advisory services to the Secretary-General on the processes of double taxation avoidance, combating tax evasion and avoidance, and strengthening the capacities of revenue administrations in developing countries and transitional economies through technical assistance and cooperation. An efficient and effective tax administration may eliminate the need to introduce higher tax rates or new taxes.

7. The ninth meeting of the Group of Experts was attended by 21 tax experts and 18 observers. The Secretariat prepared basic documents and organized two meetings of the focus group,[1] the first in New York in December 1998 and the second at Amsterdam in March 1999, for the finalization of the work on amendment of the text of the articles and modification of commentaries on the United Nations Model Double Taxation Convention between Developed and Developing Countries. The agenda for the ninth meeting was based on the discussions during the eighth meeting of the Group of Experts and on important issues in international taxation in the context of prevailing international economic, fiscal and financial environment.

8. The agenda for the ninth meeting read as follows:

1. Opening of the meeting.
2. Election of officers.
3. Adoption of agenda and organization of work.
4. Exchange of information.
5. Transfer pricing.
6. Revision and updating of the United Nations Model Double Taxation Convention between Developed and Developing Countries.
7. Other matters.
8. Arrangements for the tenth meeting.

9. The discussions on the main items in the agenda for the ninth meeting of the Group of Experts is summarized below.

II. Exchange of information

10. The Group of Experts considered the papers on the subject presented by two participants. It was observed that the exchange of information, which has implications from the bilateral tax treaty point of view, is relevant to the member countries of the United Nations in various dimensions. The Group of Experts was informed that studies on this subject have been carried out in the context of

juridical, economic and anthropological settings, and some are under way in the state of California relating to the technology gap involving ownership structures and the means employed to avoid reporting the allocation of income appropriately. A new framework has been devised to utilize databases to disaggregate ownership in affixing income. Tax information exchange is an integral part of exchange of information. Tax costs are a significant part of business equations when disparities are acknowledged. Technology has an important function in the process of exchange of information, and may provide practical solutions.

11. Another participant, in his presentation, pointed out that the increasing globalization of economic relations has created new situations requiring States to adapt their administrative structures and taxation laws in both substantive and procedural aspects. Specifically, the new economic situation requires a reappraisal of the State's position in the exercise of its powers of taxation, which in turn necessitates abandoning the concept of exercise of sovereignty, with attendant consequences.

12. Moreover, the exchange of information in the context of bilateral tax treaties establishes an access to information on a legal basis. Specifically, the exchange of information is vital for dealing with cases of fiscal fraud. The provisions relating to exchange of information in article 26 of the United Nations Model Convention have been perceived, in the context of the harmful effects of globalization of economic relations, to be inadequate and of restrictive application. One of the negative results of globalization has been the growth of harmful tax competition between States, which is utilized by persons and entities to minimize or avoid tax payments.

13. To counter these forces, States need to strengthen the machinery available for administrative assistance, on the one hand as a principal mechanism to defend their legitimate interests in obtaining an equitable tax contribution to the maintenance of their public activities, and on the other hand to permit the correct application of international instruments, namely, double taxation conventions, by respecting the rights and guarantees of the recipients of income with international character vis-à-vis over-zealous tax collectors. This is demonstrated in certain international economic areas, in which cooperation between administrations has emerged as the most effective action to deal with tax avoidance by individuals.

14. However, the effort to increase collaboration encounters several difficulties which perceptibly limit States' ability to take action to meet the new challenges of globalization. First, many States are reluctant to relinquish part of the information obtained in the exercise of their administrative authority and powers within their territory, while some States decline to seek such information from their taxpayers. Second, there is a lack of mutual interest on the part of both States in gathering and providing information. It is considered that tax-planning schemes designed to reduce the tax burden in a State utilize the legal mechanisms provided for in another State (or other States) either unilaterally or in conjunction with the application of a double-taxation convention, so that it is unlikely that the other State will have an equal interest in providing the information.

15. The representative from the Organisation for Economic Cooperation and Development (OECD) reviewed recent OECD efforts to contain harmful tax competition, and stressed the role of exchange of information in that context. OECD is primarily concerned with issues raised by financial and services sectors since companies in these businesses can easily transfer their profits to low tax jurisdictions without changing the location of their real activities. It was explained that the OECD project will result in a list of tax havens and will identify preferential tax regimes in member countries. As regards tax havens, the dialogue with these countries has led to examining cooperation approaches aimed at eliminating these jurisdictions' reliance on bank secrecy and tax havens' features in respect of their fiscal sovereignty.

16. It was emphasized that the OECD project is not intended to set minimum acceptable tax rates or to bring about harmonization of taxes across countries. The factors employed by OECD to identify countries potentially engaged in harmful tax competition were reviewed, and it was emphasized that all factors must be examined. The process and timetable for action by the OECD countries to remove harmful tax regimes was reviewed. OECD also solicits feedback from non-member countries.

17. There were several suggestions regarding the operation of the modalities of exchange of information, such as development of appropriate conditions, methods and techniques concerning the matters for exchange of information, and the need for a central organization to develop exchange of information procedures. There was also a suggestion for relaxing the rigour of several conditions for the exchange of information specified in paragraph 2 of article 26 of the United Nations Model Convention, which was opposed by another member who viewed these limits as adequate protection offered to multilateral corporations in regard to confidentiality.

18. Several members from developing countries expressed legitimate concerns at their inability to agree to full

exchange of information treaty articles in view of the unequal endowment of resources between developed and developing countries. The bank secrecy rules practised by some countries were criticized on the grounds of the difficulties that they pose to establishing tax evasion.

19. Several members of the Group of Experts emphasized the importance of utilizing new technologies to make the process of exchange of information more effective. The members from developing countries also desired that OECD countries develop effective exchange of information techniques and share those with developing countries. The exchange of information articles in bilateral tax treaties are not intended to be mere anti-abuse provisions but are necessary to implement the application of the country's tax system to cross-border transactions. Most members were of the view that the exchange of information provisions in a bilateral tax treaty are of limited benefit in dealing with the question of tax havens since most such countries do not enter into bilateral tax treaties.

20. The question of assistance in matters of collection of outstanding tax dues was discussed in the context of the exchange of information. Many members from developing countries expressed themselves in favour of such a provision in the United Nations Model Convention since many problems in this field have been experienced. The representative from OECD pointed out that OECD is working to develop a provision in bilateral tax treaties to provide assistance in matters of tax collection.

21. In conclusion, the process of the globalization of world economic relations has made greater demands on the provisions relating to exchange of information, but there are perceptible differences in the ability of developed and developing countries to obtain and provide required information to a treaty partner. The developed countries need to provide information and assistance to developing countries to enable them to carry out exchange of information procedures at an affordable cost. These procedures will also lead to the effective control of harmful tax competition.

III. Transfer pricing

22. The Group of Experts agreed that the subject of transfer pricing for transactions among associated enterprises is important for both taxpayers and tax administrators because they determine, to a large extent, the income and expenses, and consequently the taxable profits of the associated enterprises in different tax jurisdictions. In ordinary parlance, transfer pricing means the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization, and in the context of multinational corporations, primarily with a view to minimizing the aggregate tax liability of group companies.

23. Although transfer pricing distortions often arise due to the desire to minimize taxes, other non-tax issues or political factors also cause an artificial shifting of incomes to favoured divisions or a transfer of income from foreign subsidiaries to the parent corporation, primarily to permit more efficient control of funds. Although both United States transfer pricing regulations and the OECD guidelines are based on the "arm's length" principle, developing and transitional economy countries have experienced serious difficulties in its application due to limited markets in many types of goods, services and lack of availability of comparable prices.

24. In their initial discussion, the Group of Experts referred to the need to provide technical training for tax administrators from developing and transitional economy countries in transfer pricing methodologies and techniques, and also referred to the issue of improving tax collections from multinational corporations and the implementation of effective mutual agreement and exchange of information procedures for all countries. In this context, the Group of Experts was informed that the United Nations had successfully organized the First Interregional Training Workshop on International Taxation, with a focus on transfer pricing; the Workshop was convened at Amsterdam in March 1999, in association with the International Bureau of Fiscal Documentation.

25. Recent developments on transfer pricing issues were reviewed by the representative of OECD, including the work of monitoring the use of the OECD guidelines by member countries, studying the application of the guidelines to the permanent establishment situations, publishing the "advance pricing agreements" (APAs) and studying the question of the inclusion of dispute resolution procedures in tax treaties. He explained that the OECD guidelines have been expanded by examples showing how these guidelines should be applied, particularly with respect to the profit-split methods and intangibles.

26. An advance pricing arrangement determines, in advance of controlled transactions, an appropriate set of indicators, namely, method, comparables and appropriate adjustments thereto, critical assumptions as to future events for the determination of the transfer pricing for those transactions over a fixed period of time. These are aimed at

supplementing the normal administrative, judicial and treaty mechanisms for resolving transfer pricing disputes. The Group of Experts discussed extensively the use of and experience with APAs. It was agreed that while unilateral APAs may pose several problems from the point of view of tax administrators who may disagree with their formulation, bilateral and multilateral APAs represent the preferred approach.

27. However, APAs place a strain on transfer pricing audit resources, since tax administrators are constrained to divert resources earmarked for other purposes. There are problems if tax administrations misuse the information obtained in an APA in their normal assessment procedure, or if the confidentiality of trade practices or other sensitive information and documentation is not maintained. Although there was no consensus on the merits of unilateral APAs, it was considered by some members that they have proved valuable in establishing a useful basis in mutual agreement procedure.

28. There was general agreement on the basic methodologies to be applied by countries in determining appropriate transfer prices. The difficulties in applying the arm's length principle may be reduced by providing circumstances in which taxpayers can follow a simple set of rules under which transfer prices would be automatically accepted by the national tax administration, which are referred to as "safe harbours". While some countries tend to use "safe harbours" to provide a measure of simplification, the Group of Experts observed that they may depart from the "arm's length" principle and also lead to double taxation and opportunities for tax arbitrage. It was noted that a parallel multilateral organization had specifically recommended that countries not employ safe harbours.

29. It was generally agreed that the transfer pricing issue is of great importance to both developed and developing countries. The suggestion to establish an institutional framework for the arbitration of transfer pricing disputes, which would be of considerable assistance to developing countries, did not evoke a favourable consensus. It was pointed out that although the European Union has an arbitration convention and a few bilateral tax treaties do include provisions for arbitration, it would be desirable to await the experience of these measures before reaching a conclusion on an arbitration procedure. It was observed that an arbitration procedure is not a substitute for developing expertise in transfer pricing issues or for training or a mutual agreement procedure, and must be treated as a procedure of last resort for resolving transfer pricing disputes. There was general agreement that only multi-country or regional basis agreements should lead to the adoption of an arbitration procedure.

30. The Group of Experts emphasized the role of technical assistance programmes under the aegis of the United Nations for upgrading the technical skills of tax administrators from developing countries and transitional economies in such areas as transfer pricing methodologies and procedures.

IV. Revision and updating of the United Nations Model Double Taxation Convention between Developed and Developing Countries

31. In 1982, the Economic and Social Council had drawn the attention of the Ad Hoc Group of Experts to the need to continue its work by making appropriate proposals in the field of taxation, including its examination of the United Nations Model Convention and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, as well as the experience of countries in bilateral application of the United Nations Model Convention.

32. The process of revision and update of the United Nations Model Convention finds further justification in the increasing sophistication of the world economy, which poses significant challenges to different tax systems. The establishment of the World Trade Organization has reinforced additional impetus to reduce the tariff and other tax-related barriers to promote the exchange of goods, services and movements of capital and persons across national boundaries. During the past 10 years, the world has witnessed the emergence of the transitional economies, which are facing several challenges on the economic front. They are seeking more effective ways for improved financial resources mobilization to ensure sustainable economic development. Currently, there is greater emphasis on establishing a permanent international institutional framework to facilitate the conclusion of tax treaties with a view to promoting trade liberalization and expansion, as well as socio-economic growth with social justice. The economic orientation of the bilateral tax treaties has to reckon with the aspirations of the emerging economies for rational international income allocation and resultant tax revenues.

33. The conclusion of bilateral tax treaties for the prevention or elimination of double taxation has emerged as an important constituent of intergovernmental economic relations. Such treaties have been negotiated in the light of

various monetary, fiscal, social and other policies important to the negotiating parties. Bilateral tax treaties can solve many double taxation problems by reconciling differences in the concepts of various types of income and their geographical source, establishing a common method of determining the classification of certain items of income and their tax treatment, and either assuming exclusive tax jurisdiction over certain items of income to one of the treaty countries or dividing the tax revenue between the two countries when neither is willing to relinquish its claim entirely. Bilateral tax treaties promote orderly international tax relationships resulting in the exchange of fiscal information and procedures for mutual assistance, and facilitate the establishment of level playing fields between local businesses and those owned by foreign investors due to the operation of non-discriminatory clauses of such treaties.

34. The United Nations Model Convention represents a compromise between the source principle[2] and the residence principle,[3] although it gives more weight to the source principle than do other model conventions. As a correlative to the principle of taxation at source, the articles in the United Nations Model Convention are predicated on the recognition by the source country that first, the taxation of income from foreign capital would be taxed on a net basis after deduction of expenses; second, taxation would be at reasonable rates to encourage investment; and third, it would appropriately share the revenue with the capital-exporting country. In addition, the United Nations Model Convention promotes the principle of the extension of a measure of relief from double taxation by the residence country through either foreign tax credit or exemption. Like all model conventions, the United Nations Model Convention is intended primarily to point the way towards feasible approaches to the resolution of the issues involved that both potential contracting parties are likely to find acceptable. Its aim is to facilitate the negotiation of tax treaties by eliminating the need for elaborate analysis and protracted discussion of every issue *ab origine* in the case of each treaty.

35. At its eighth meeting, the Group of Experts appointed a focus group of five members and four alternates to do preliminary work on the revision and updating of the United Nations Model Convention, and to report the results of its work to the Group of Experts at its ninth meeting. The focus group held two meetings, in December 1998 in New York and March 1999 at Amsterdam, and examined the comments and suggestions for the amendment of the text of the articles and modification of the commentaries on the United Nations Model Convention. The reports of the focus group on its first and second meetings were before the Group of Experts at its ninth meeting.

36. The Group of Experts, while considering the revision and update of the United Nations Model Convention, took into account the significant changes in the international economic, fiscal and financial environment which have taken place in the last two decades, as well as the modifications introduced in the model conventions of other parallel multilateral and intergovernmental organizations.

37. The amendments made to the text of the articles of the United Nations Model Convention were intended first, to rationalize the provisions of articles dealing with dividends, interest and royalties; second, to remove anomalies and doubt about their application; third, to expand the scope of anti-abuse provisions relating to associated enterprises and capital gains; and fourth, to introduce a measure of administrative simplification in articles dealing with independent personal services and mutual agreement procedures. As a result, the text of the articles will be seen as homogeneous, coherent and reflecting the underlying intent in a comprehensive manner.

38. The process of modification of the commentaries on the United Nations Model Convention aimed to explain the genesis and rationale of the various existing and new provisions, a proper comparison with corresponding identical or differing provisions in other model conventions, and the removal of several extracts and paragraphs which, over the years, have outlived their utility or become irrelevant.

39. One of the major points of discussion at the ninth meeting concerned the treatment to be accorded to the subject of "tax sparing" in the commentary on article 23 of the United Nations Model Convention on methods for the elimination of double taxation. Tax sparing is the practice of adjusting home country taxation of foreign investment income to permit investors to receive the full benefits of host country tax reductions. There was considerable difference of opinion among members of the Group of Experts about the impact of the grant of tax sparing to foreign investors on the flow of foreign direct investment towards developing countries and transitional economies. It was decided by the Group of Experts to note the discussions on the subject without drawing any conclusions in the matter.

40. The Group of Experts examined the text of every article and each and every paragraph of the commentaries on the United Nations Model Convention. Thereafter, **the Group of Experts adopted by acclamation the United Nations Model Double Taxation Convention between Developed and Developing Countries (revised version),**

40. The Group of Experts examined the text of every article and each and every paragraph of the commentaries on the United Nations Model Convention. Thereafter, **the Group of Experts adopted by acclamation the United Nations Model Double Taxation Convention between Developed and Developing Countries (revised version), which will be published by the United Nations Secretariat shortly.**

V. Technical training

41. The Group of Experts was aware that an efficient and effective revenue administration can help developing countries and transitional economies to mobilize additional revenue resources and achieve greater financial self-reliance in facilitating and achieving sustainable economic development. Moreover, the need to introduce higher tax rates or new taxes can be reduced or eliminated by strengthening the revenue administration through upgrading the technical skills of tax administrators by intensive training, especially in the complex and intricate area of international taxation.

42. The Group of Experts referred to the discussions at the eighth meeting in December 1997, which pointed to the need to provide training in international taxation to tax administrators from developing countries and transitional economies. The Group of Experts was informed that the United Nations, in association with the International Bureau of Fiscal Documentation, had organized the First Interregional Training Workshop on International Taxation, with an emphasis on transfer pricing and other related issues, at Amsterdam from 22 to 26 March 1999. The Workshop was attended by tax administrators from 14 countries in Africa, Asia, Europe, Latin America and the transitional economies. The Workshop was a success judging by the comments of the participants. The Group of Experts was informed that the United Nations had plans to organize more such workshops in international taxation, including some on practical methods and strategies for combating tax avoidance and evasion, subject to satisfactory financial arrangements.

43. It is relevant to mention that subsequent to the ninth meeting the United Nations has proposed holding the Second Interregional Training Workshop on International Taxation at Rio de Janeiro, in association with the Government of Brazil. The full details of the organization of the Workshop are still to be finalized.

44. The Group of Experts, in all its deliberations, has emphasized the importance of coordination of the proposed technical assistance and cooperation programmes with other parallel international organizations.

VI. Recommendations

45. The Group of Experts recommended that the United Nations Secretariat publish as soon as possible the United Nations Model Double Taxation Convention between Developed and Developing Countries. The Group of Experts also decided to keep the United Nations Model Double Taxation Convention under a biennial revision process.

46. The Group of Experts has suggested the following items for its review during its forthcoming meetings:

(a) Transfer pricing;

(i) Advance pricing agreements;

(ii) Arbitration as a means of dispute resolution;

(b) Innovative financial instruments;

(c) Tax implications of electronic commerce, including the scope of the permanent establishment concept;

(d) Exchange of information;

(e) Mutual assistance in collection of tax debts;

(f) Pensions;

(g) Alternative dispute resolution procedure;

(h) Tracking changes in the OECD Model Convention;

(i) Examining the revisions of regional model conventions.

47. On the basis of the decision of the Group of Experts (see para. 40 above), the Council may wish to take note of the revised United Nations Model Double Taxation Convention between Developed and Developing Countries, and to approve the holding of the tenth meeting of the Group of Experts in the first half of 2001.

Notes

[1] At its eighth meeting, the Group of Experts established a focus group, consisting of five members and four alternates, to undertake the task of revising and updating the United Nations Model Double Taxation Convention between Developed and Developing Countries, and to report the results of its work to the Group of Experts at its ninth meeting.

[2] Under the "source" principle, a State taxes all income earned from sources within its territorial jurisdiction.

[3] Under the "residence" principle, a State taxes the worldwide income of persons residing within its territorial jurisdiction.